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IN THE

Supreme Court of the United States

OCTOBER TERM, 1948.

No. 151.

NATIONAL CARBIDE CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 152.

AIR REDUCTION SALES COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 153.

PURE CARBONIC, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR PETITIONERS.

ERWIN N. GRISWOLD
BOYKIN C. WRIGHT
EDGAR J. GOODRICH
JOHN A. WILSON
Counsel for Petitioners

SHEARMAN & STERLING & WRIGHT
20 Exchange Place
New York 5, N. Y.
Of Counsel

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Respondent.

BRIEF FOR PETITIONERS.

Statement.

This is a review on writs of certiorari of the decision and judgments of the United States Circuit Court of Appeals for the Second Circuit which reversed the decisions and orders of The Tax Court of the United States in these proceedings.

The Tax Court, thirteen of the sixteen judges concurring, had set aside determinations by the

Commissioner of Internal Revenue of deficiencies aggregating $1,066,253.10 in the 1938 corporation income and declared value excess profits taxes of petitioners.

Opinions Below.

The opinion of the Circuit Court of Appeals (R. 274-280) is reported in 167 F. (2d) 304.

The findings of fact and opinion of the Tax Court (R. 6-35) are reported in 8 T. C. 594.

Jurisdiction.

A petition for writs of certiorari was filed on July 14, 1948 (R. 290) and was granted by orders of this Court entered October 11, 1948 (R. 289).

The jurisdiction of this Court rests on Section 240 of the Judicial Code as amended by the Act of February 13, 1925, now Section 1254 of Title 28, United States Code.

Questions Presented.

The questions presented are as follows:

1. Where no question of "sham" or of "disregard of corporate entities" is involved, may a subsidiary corporation be the agent of its parent so that the income from its operations is properly taxable to the parent, as the Tax Court has held?

2. Should legal effect be given to express agency contracts between subsidiaries and their parent, which were always followed in all respects in all operations between them?

3. Whether this Court's decision in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, "still stands", as decided by the Tax Court, or is "no longer controlling", as decided by the court below?

4. Can a Circuit Court of Appeals properly reverse a decision of the full bench of the Tax Court in which the Tax Court expressly found and held that subsidiaries "were corporate agents" of their parent, and that the income from their operations "belonged to and was the income and property" of the parent "as principal"?

Statutes and Regulations Involved.

These cases do not involve the construction or application of any specific statutes or regulations bearing directly on the issues.

Summary Statement of Facts.

The facts found by the Tax Court (R. 6-28) establishing the agency relationship between the petitioners and their parent, may be summarized as follows:

Each of the three petitioners was a wholly owned subsidiary of Air Reduction Company, Incorporated, commonly known and herein sometimes referred to as "Airco" (R. 8). Airco, the parent company, was engaged in the manufacture of gases and also of equipment for gas and electric-arc welding, cutting and heat treatments of metals. It utilized the three petitioners in three related branches of its business (R. 8-9, 12, 21).

The Agency Contracts.

With each subsidiary, Airco had an operating contract which expressly provided that the subsidiary was employed by Airco "as its agent." These contracts follow the pattern established on March 1, 1917 in the contract between Airco and Air Reduction Sales Company (R. 13, 21).

In each contract Airco agreed to give each subsidiary the use of all gas cylinders and containers, trucks, equipment and shipping facilities which it owned; to supply each subsidiary with working capital; and to provide executive management and office accommodations and facilities for each (R. 13, 16-17, 18-19).

All assets held and used by the three subsidiaries were furnished to them by Airco which had paid for them with its own cash or by exchange for Airco's stock. All working capital was supplied by Airco (R. 22, 21).

In consideration of Airco furnishing these assets and services, each contract provided, among other things, that the subsidiary should "credit monthly on its books to Airco all profits accruing to it from the operation of its entire business over and above an amount equal to six per cent. (6%) per annum of its outstanding capital stock" (R. 14, 17, 19).

Some of the salient facts found by the Tax Court, in addition to those relating to the operating contracts, which establish that the business of Airco was conducted through its subsidiaries as agents, were:

Board of Directors.

The Airco Board held regular meetings, determined the general policies, and completely controlled the business of Airco and each subsidiary (R. 28, 23).

Directors of the subsidiaries, with one minor exception, were all senior officers of Airco. These Boards held an organization meeting each year and thereafter met only to formalize action taken by the Airco Board (R. 22, 28).

Officers.

The officers of the subsidiaries were the officers of Airco and they exercised complete control and management over the business of each of the subsidiaries in accordance with the policies and directions of the Airco Board (R. 22, 23). Airco maintained one general office in New York for all companies (R. 21, 23).

Branches of the Business.

The business of Airco and the subsidiary companies was divided into six main branches, each headed by an officer of Airco. These branches were: Corporate, Operations, Sales, Financial, Distribution and Research. All employees in these branches performed their duties whenever and wherever required in connection with the operations of all companies (R. 23-28).

Appropriations and Purchases.

Expenditures for any company between $50 and $500 required the approval of an executive officer of Airco and those in excess of $500 required the specific approval of Airco's Board of Directors and its Chairman (R. 25).

Products produced by or materials purchased for one subsidiary were often transferred to another subsidiary and, where this was done, the transfer was reflected on inter-company accounts at cost without the transfer of any cash (R. 25).

Bank Accounts.

Bank accounts in the names of the subsidiaries were drawn upon by Airco indiscriminately whenever cash was needed for its own use or for any subsidiary no matter in whose name the account was kept (R. 25-26). There was substantial identity of officers authorized to sign checks on all accounts (R. 26).

Accounting.

All accounts were kept strictly in accordance with the operating contracts (R. 27). The value of all assets held and used by each subsidiary, all working capital furnished to it and the net proceeds from its operations in excess of its compensation under its contract, were credited to the accounts payable by the subsidiary to Airco and were debited to the accounts receivable by Airco from the subsidiary. No interest ran on any of these accounts (R. 21-22, 27).

There were no inter-company profits (R. 25, 32). None of the subsidiaries declared dividends (R. 32, 27).

Tax Returns.

During 1938, as in prior years, Airco reported as its own all income from its operations through the subsidiaries, in excess of the amount of each subsidiary's contract compensation, and paid taxes thereon accordingly (R. 11-12). Airco also declared a capital stock value of $72,981,000 for the year ended June 30, 1938 and paid a capital stock tax of $72,981. Airco's 1938 income tax return showed no declared value excess profits tax liability because 10% of the declared value ($7,298,100) exceeded its adjusted net income of $4,227,295.09 (R. 12).

Petitioners, as in prior years, declared values for their capital stock, paid capital stock taxes thereon, and paid income taxes upon the respective amounts of their contract compensation (R. 9-11).

The method by which Airco conducted its business and all details of the relationships between it and its subsidiaries were always fully disclosed to the Government and to the Commissioner (R. 28).

Adjustments Made by the Commissioner.

In 1938, for the first time, the Commissioner disregarded the operating contracts and long established pattern of Airco's operation, eliminated from Airco's return the amounts credited to Airco on the books of each subsidiary and increased the income reported by the three subsidiaries by these amounts.

The Commissioner then apportioned expenses of Airco ($415,000) between Airco and the subsidiaries. However, the Commissioner erred even in applying his own theory in that he did not make any such allocation of the deduction of $7,298,100, representing ten per cent of the declared value of Airco's capital stock used in computing its declared value excess profits tax liability (R. 6-8, 38-42).

The result was a large deficiency, which is in net effect almost wholly one of Declared Value Excess Profits Tax, resulting from attributing substantial incomes to the subsidiaries while giving them no benefit from the capital stock tax declaration of the parent.

If Airco had known that the Commissioner would change his position and refuse to accept for 1938 and later years Airco's method of reporting income, which he had accepted in prior years, Airco could properly

have made different capital stock declarations for itself and its subsidiaries, thus removing any possibility of a claim for Declared Value Excess Profits Taxes.

Decision of the Tax Court.

In the Tax Court the proceedings were tried before Honorable Eugene Black and reviewed by the entire court. Thirteen judges concurred in the decision; only three dissented and they without opinion.

The Tax Court stated that the issue before it was:

> ". . . Whether, as the respondent has determined, the income from the operations of the three petitioners belonged not to Airco, the parent, but to the petitioners and was taxable to them; or whether, as the three petitioners contend, the income from the operations of the petitioners in 1938, exclusive of the small amounts paid to petitioners under the contracts, belonged and was taxable to Airco, the parent company, both because the petitioners were in fact incorporated departments, divisions or branches of Airco's business and because the petitioners operated pursuant to express contract with Airco" (R. 29).

On all the evidence, the Tax Court's finding of ultimate fact was that:

> "Petitioners were the *corporate agents* of Airco and were operated as incorporated branches or divisions of Airco. The income from the operations of petitioners which is in excess of six per cent of petitioners' outstanding capital stock belonged to and was the income and property of Airco *as principal*" (R. 28; italics ours).

Therefore, the Tax Court held: "That there are no deficiencies in income tax and declared value excess profits tax for the calendar year 1938" (R. 4, 5).

Decision of the Circuit Court of Appeals.

The Circuit Court of Appeals refused, however, to accord any tax consequence to the principal-agent relationship found as a fact by the Tax Court, saying:

> "'Airco' found it more convenient in its manufacture and distribution to adopt a quadripartite form than to deal directly with third persons itself. Whatever its reasons, they were business reasons, and the corporations it used were 'corporations' within any interpretation of the law. That is enough; it must accept the consequences of that choice; and it is not material that it retained the direction of their affairs down to the minutest detail, that it provided them with their assets, that it stood back of their liabilities and took all of their profits" (R. 279).

The Tax Court had cited *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, as "aptly descriptive of the relationship" between petitioners and Airco (R. 30). But the Circuit Court of Appeals, after discussing *Moline Properties, Inc.* v. *Commissioner,* 319 U. S. 436, said:

> "Even though *Southern Pacific Co.* v. *Lowe, supra,* set up a different test, we regard it as *pro tanto* no longer controlling" (R. 279).

The Circuit Court of Appeals refused to hold that the proceeds from the operations of the subsidiaries payable to Airco was the income of Airco. On petition for rehearing the petitioners then urged that these proceeds should, in view of that finding, be held

to be deductible expenses of the subsidiaries (R. 284-7). But the Court denied the petition without opinion (R. 288).

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In holding that a subsidiary corporation cannot be the agent of its parent so that the income from the operations of the subsidiary is in law, as well as in fact, the income of the parent.

2. In failing to give legal effect to clear and bona fide operating contracts between the subsidiary corporations and their parent under which the subsidiaries became agents of their parent, and in failing to hold that the amounts payable to the parent under the contracts are the income of the parent, as principal, taxable to it.

3. In holding the decision of this Court in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, to be "*pro tanto* no longer controlling".

4. In failing to hold, if the income is to be treated as belonging to the subsidiaries, that amounts payable by the subsidiaries to Airco pursuant to bona fide operating contracts were deductible as ordinary and necessary business expenses of the subsidiaries.

5. In exceeding its powers of review by reversing the Tax Court which had expressly found and held that the subsidiaries were "the corporate agents" of their parent and that the income from the operations of the subsidiaries "belonged to and was the income and property of Airco as principal".

Summary of Argument.

I.

Corporations are separate juristic persons, and they are normally so treated for tax purposes. Mere ownership by one corporation of all the stock of a subsidiary does not of itself merge the two corporations or create the relationship between them of principal and agent.

However, this Court has unmistakably indicated that where, as here, there is either "an actual contract of agency" or "the usual incidents of an agency relationship", between a parent and its subsidiary, the income produced through the operations of the subsidiary is the income of the parent, as principal. In *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, it recognized and gave effect to that agency principle. That case has never been overruled, and in *Moline Properties, Inc.* v. *Commissioner*, 319 U. S. 436 and *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, this Court clearly intended to preserve its applicability in the field of agency.

The proof received in this case, at a four day trial, overwhelmingly established the existence of the principal-agent relationship between Airco and its subsidiaries. On the basis of this evidence, the Tax Court found that the subsidiaries were "the corporate agents of Airco" and "were operated as incorporated branches or divisions of Airco", and that the income from the operations of the subsidiaries in excess of their agreed agency compensation "was the income and property of Airco as principal". Moreover, the Circuit Court of Appeals did not dispute that finding.

On the contrary, in its decision in *Railway Express Agency, Inc.* v. *Commissioner,* 169 Fed. (2d) 193, it expressly confirmed that it regarded the subsidiaries, in the present case, as the corporate "agents" of Airco.

Therefore, the Circuit Court of Appeals erred in failing to hold, with the Tax Court, that the income earned through the subsidiaries was taxable to Airco and not to the subsidiaries.

II.

The Circuit Court of Appeals held that each subsidiary was a separate corporation, and regarded each as an agent of Airco. Also, it accepted the contracts under which Airco furnished to the subsidiaries, all assets, working capital and all other instrumentalities used in the production of income as bona fide operating contracts. Nevertheless, it held that the amounts payable under the contracts to Airco by the subsidiaries, belonged and were taxable to the subsidiaries, and refused to give effect to the finding of the Tax Court that these amounts were the income of Airco.

In this event, however, the Circuit Court of Appeals should have held that the amounts so payable were deductible by the subsidiaries as ordinary and necessary expenses of their business. Section 23(a) Revenue Act of 1938; *Interstate Transit Lines* v. *Commissioner, supra; Custom Casing Co., Inc.* v. *Commissioner,* 2 T. C. M. 58 (1943).

III.

The Circuit Court of Appeals was bound by the finding of the Tax Court that the principal-agent relationship existed and that the income from the opera-

tions of the subsidiaries, apart from their agency compensation, was the income of Airco. The question of the ownership of income arising out of inter-corporate relationships and operations basically presents factual issues. Whether an agency relationship existed between Airco and its subsidiaries and whether Airco or its subsidiaries were the true "economic earners" of the income were essentially questions of fact.

If this case be regarded as coming under the *Dobson* Rule, which was still in effect at the time of the Circuit Court of Appeals' decision, then surely it involved a matter of "proper tax accounting", and the Tax Court's determination should have been accorded finality.

If, however, it should be deemed governed by the principles of review applicable since the abrogation of the *Dobson* Rule the finding of the Tax Court should nevertheless be accorded finality. Rule 52(a) R. C. P.; *United States* v. *United States Gypsum Co.*, 333 U. S. 364. For the Circuit Court of Appeals did not disagree with the Tax Court's finding that the principal-agent relationship existed. Nor did it hold that there was no evidence to support that finding or that the finding was in any degree erroneous. On the contrary, it affirmatively pointed out that Airco employed the subsidiaries "as its agents".

Therefore, whether this case be regarded as coming under the *Dobson* Rule or under the scope of review applicable before that rule or presently applicable, the decision of the Circuit Court of Appeals was erroneous in that the Court exceeded its powers of review.

Argument.

POINT FIRST.

The subsidiary corporations were the agents of Airco so that the income from their operations was in law, as well as in fact, the income of Airco, as principal, taxable to it, and not to its subsidiaries.

I.

The Tax Court sustained the validity of the agency contracts between Airco and its subsidiaries, pointing out: that the policy of operating under these contracts originated in 1917; that each contract has remained unchanged and in full force from its inception down to the present time; that the method by which Airco conducted its business through corporate agencies was consistently adhered to; and that all details of the relationship between Airco and each of these subsidiaries was fully disclosed to the Government and the Commissioner (R. 13, 21, 28).

As the record thoroughly establishes, the agency contracts were business arrangements representing the actual relationships between the corporations. Moreover, they were justifiable and reasonable as appears from these facts, among others: that Airco furnished to the subsidiaries all assets, working capital, and all other instrumentalities used in the production of income. The contracts were not some clever documentary scheme for purposes of tax evasion.

The record is full of evidence establishing the principal-agent relationship. This Court need not review that evidence. It is fully reflected in the findings of the Tax Court charged with the determination of fact matters in tax cases.

On the basis of all the evidence the Tax Court found (R. 28):

> "Petitioners were the *corporate agents* of Airco and were operated as incorporated branches or divisions of Airco. The income from the operations of petitioners which is in excess of six per cent. of petitioners' outstanding capital stock belonged to and was the income and property of Airco *as principal*." (Italics ours.)

Moreover, the Circuit Court of Appeals did not disagree with this finding nor decide that there is no evidence to support it. On the contrary, in its recent decision in *Railway Express Agency, Inc.* v. *Commissioner,* 169 Fed. (2d) 193, decided July 19, 1948, the Circuit Court of Appeals, referring to this case, specifically pointed out:

> "So, too, it should be noted that there the subsidiaries were employed by the parent Company *as its agents*" (p. 196; italics ours).

Thus, the Tax Court and the Circuit Court of Appeals are agreed that in this case the subsidiaries were the agents of their parent Airco. But the Circuit Court of Appeals unlike the Tax Court accorded that fact no tax consequence.

II.

The Tax Court cited *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, as "aptly descriptive of the relationship which existed between petitioners and their parent Airco in the instant case." The issue in that case was not the same as here. But, the factual relationship there was similar to that in the present

case, and the decision is important because this Court there recognized and gave effect to the agency principle for which we contend. In that case, as in ours, control of the subsidiary by the parent was so complete that this Court found, as a matter of fact, that the subsidiary was merely *an agent* of the parent.

In 1914 the subsidiary had declared dividends and paid them out of surplus accrued prior to March 1, 1913. The payment was carried into effect by bookkeeping entries. The question was whether the dividends thus received by the parent were taxable as income to the parent in 1914.

This Court held that the payments were not taxable to the parent because the parent and the subsidiary were in substance identical, saying (p. 337):

> "While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, *acting merely as its agent* and subject in all things to its proper direction and control." (Italics ours.)*

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* In *Peabody* v. *Eisner*, 247 U. S. 347, decided the same day as the *Southern Pacific* case, this Court said, at page 349:

> ". . . *Southern Pacific Co.* v. *Lowe*, has been reversed this day, *ante*, 330, but only upon the ground that the Central Pacific Railway Company which paid the dividend, and the Southern Pacific Company, which received it, were in substance identical corporations because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely as its agent and subject in all things to its direction and control; and for the further reason that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend."

The present case is also one of agency, as the Tax Court found. After quoting the above language from *Southern Pacific* v. *Lowe*, the Tax Court said (R. 30):

> "We think the foregoing words of the Supreme Court are aptly descriptive of the relationship which existed between petitioners and their parent, Airco, in the instant case."

A little later it said (R. 32):

> ". . . We think, however, that when all these facts are viewed together they bring petitioners within the rule announced by the Supreme Court in *Southern Pac. Co.* v. *Lowe, supra.*"

Finally, the Tax Court referred to the fact that the Commissioner had accepted returns from the taxpayers for the years 1935, 1936 and 1937, on the basis for which they now contend, and concluded (R. 35):

> ". . . Nevertheless, we think that his apparent interpretation of the law in 1935, 1936, and 1937 as it affected petitioners was correct and that the rule announced by the Supreme Court in *Southern Pac. Co.* v. *Lowe, supra,* still stands."

It is clear, therefore, that the full bench of the Tax Court regards *Southern Pacific Co.* v. *Lowe* as still law in cases of agency, and that it considered the present case to be a clear case of agency. But, the Circuit Court of Appeals has refused to recognize the effect of an actual agency relationship although this Court did recognize it in the *Southern Pacific* case. The Circuit Court of Appeals regarded the *Southern Pacific* decision as one which this Court "is not willing any longer to treat as authoritative", and held that it is "no longer controlling" (R. 277, 279).

On the contrary, the continuing validity of the

Southern Pacific case within the field of actual agency relationship has been recognized by this Court in recent decisions. Thus, in *Moline Properties, Inc.* v. *Commissioner*, 319 U. S. 436, which was heavily relied upon by the Court below although its facts were wholly dissimilar, this Court had expressly pointed out (p. 440):

> ". . . There was no actual contract of agency nor the usual incidents of an agency relationship."

In the *Moline* case this Court clearly recognized the principle that tax consequences do flow from the principal-agent relationship. But it refused to apply that principle because the facts did not establish the existence of that relationship.

Moline was organized by Thompson, its sole stockholder, at the suggestion of a bank, to protect a second mortgage held by the bank on four lots owned by Thompson and to secure an additional loan. Sometime later when the loan had been discharged, Moline sought to have the gain on sales of its real property treated as the gain of Thompson.

But, on the particular facts, this Court held that the gains were taxable to Moline, pointing out: that from its inception Moline had a special function; that it was "clearly not Thompson's *alter ego*"; that "his exercise of control over it was negligible"; that there was no "actual contract of agency, nor the usual incidents of an agency relationship"; that on the facts before the Court Moline "had a tax identity distinct from its stockholder"; and therefore that the capital gains belonged and were taxable to Moline and not to Thompson.

In the present case there are contracts of agency; all the usual incidents of agency relationship are

present; and the Tax Court expressly found and the Circuit Court of Appeals in the *Railway Express Agency* case confirmed, that the petitioners were the corporate agents of Airco (*supra*, p. 15).

Likewise, in *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, this Court said (p. 593):

> "This is not the case of a mere branch or division of a business conducted solely for convenience's sake under a separate corporate form."

Thereby, this Court pointed to the absence, in that case, of an important relationship, present in this case, in which the Tax Court has expressly found that the "Petitioners . . . were operated as incorporated branches or divisions of Airco" (R. 28).

In the *Interstate Transit* case, the petitioner, Interstate, a foreign corporation, operated an interstate bus line between Illinois and California and Missouri and Wyoming. Under California law, prior to 1937, Interstate, being a foreign corporation, was prohibited from doing an intrastate business in California.

To handle such intrastate business on its buses, Interstate organized a California bus corporation referred to as "Stages". It made an agreement with Stages that Stages would take over the operation of Interstate's buses at the state line and operate them in California for Interstate's benefit and under its direction, the profits to be paid to Interstate and any deficit to be borne by it.

In 1936, Stages had an operating deficit which Interstate paid, pursuant to its agreement, and deducted as an expense of its own business. The decision of the

majority of this Court disallowing the deduction was placed squarely upon the ground that Stages was engaged in a business which Interstate could not lawfully do, hence that Interstate could not claim the deduction.

In that case, however, in both prevailing and minority opinions, this Court again recognized that a bona fide operating contract between a parent and a subsidiary may have tax consequences. The decision of the majority, through Mr. Justice Reed, assumed the validity of the contract, and disallowed the claimed deduction only upon the ground that the subsidiary was engaged in an intrastate business which Interstate could not legally do.

However, the majority opinion indicated unmistakably that if the record before the Court had segregated the interstate business which Stages could "legally" do, for Interstate, from the intrastate business which Stages could not "legally" do, for Interstate, the allowance to Interstate of that portion of the claimed deduction attributable to such "legal" business would have been approved pursuant to the contract between them (pp. 593-4).

Mr. Justice Jackson, however, in his dissenting opinion (Chief Justice Stone and Mr. Justice Murphy concurring) called the arrangement and the contract between the two corporations a "commonsense business arrangement", and they were of the opinion that the deduction was allowable in any event.

Thus, the decision of the Circuit Court of Appeals in the present case erroneously rejects *Southern Pacific* v. *Lowe*, and applies recent decisions of this

Court to a factual situation which was expressly excepted in those recent decisions. *Southern Pacific Co.* v. *Lowe*, has never been overruled and this Court in its opinions in the *Moline Properties* and *Interstate Transit* cases undoubtedly intended to preserve its applicability in the field of agency. It unmistakably indicated that where there is either "an actual contract of agency" or "the usual incidents of an agency relationship", the income produced through the operations of the agency company is the income of the parent, as principal.

POINT SECOND.

The Circuit Court of Appeals erred in failing to hold, that if the income is to be treated as belonging to the subsidiaries, the amounts payable by the subsidiaries to Airco were deductible as ordinary and necessary business expenses of the subsidiaries.

I.

The Circuit Court of Appeals held that each subsidiary was a separate corporation "within any interpretation of the law", although it regarded each subsidiary as an agent of Airco (*supra*, pp. 9, 15). Further, it accepted the contracts under which Airco furnished to the subsidiaries all assets, working capital and all other instrumentalities used in the production of income, as bona fide operating contracts. Nevertheless, the Court failed to hold that the amounts payable under the contracts to Airco, by the subsidiaries, in consideration, were the income of Airco.

The Circuit Court of Appeals having refused to hold that the amounts so payable were the income of Airco,

we submit that it was faced with the inescapable alternative of holding that these amounts were necessary business expenses of the subsidiaries, deductible as such by them. That contention was implicit in the position of the taxpayers and was squarely presented to the Court on petition for rehearing; but the Court denied the petition without opinion, refusing to accord to the contracts any legal effect whatsoever (R. 284-288).

That the Circuit Court of Appeals should, in the alternative, have held that the amounts so payable to Airco were deductible by the subsidiaries as ordinary and necessary expenses of their business seems unquestionable. *Section 23(a) Revenue Act of 1938.**

Thus, in the *Interstate Transit Lines* case, *supra*, pp. 19-20, the majority of this Court held that the expense there involved was not a "rightful deduction under Section 23(a)" only because the intrastate business of Stages could not properly be regarded as Interstate's business, since Interstate, itself, could not legally do intrastate business in California (p. 594). But, the implication of the majority opinion is clear that, but for that exceptional circumstance, the expense would have been deductible as an obligation of Interstate under its contract with Stages. The minority opinion, on the other hand, gave full legal effect to the contract and concluded that the inability of Interstate legally to do intrastate business in

* "Sec. 23 Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses. All the ordinary and necessary expenses paid or incur during the taxable year in carrying on any trade or business. "

California was not a valid ground for the disallowance of the claimed deduction.

More than four years before the Tax Court decided the present cases, it decided *Custom Casing Co., Inc. v. Commissioner of Internal Revenue*, 2 T. C. M. 58 (1943). That case, strikingly similar to this on the facts, also involved express agency contracts between a parent and its subsidiaries with all the usual incidents of agency operation. It too raised the question whether income from operations of the subsidiaries belonged to the parent. The Tax Court there held, as it did in the present case, that the income belonged to the parent. But, in the course of its opinion the Court considered also whether the inter-company agency contracts could give rise to a deductible business expense, and concluded (p. 76):

> ". . . if we consider the subsidiary-agents as separate corporate entities, we must give effect to the agency contracts executed between them and Hygrade and come to the conclusion indicated above: that Hygrade is . . . entitled to deduct any losses incurred by the subsidiary-agents pursuant to the agency contract which Hygrade was obligated to pay and which, in fact, it did pay."

II.

The "contention" that the amounts payable to Airco should, in the alternative, have been held to be deductible expenses of the subsidiaries was inherent in the issue presented in the Tax Court, and was never waived (R. 34).

The Commissioner had held that all income produced by the operations of the subsidiaries belonged to them and not to Airco. He also apportioned to

each subsidiary such part of the total expenses paid or accrued by Airco ($415,000) as he deemed attributable to the operations of each subsidiary. In response to an inquiry of the Court, counsel for petitioners agreed that there was then no controversy regarding the "amount of income" and the "amount of expenses" which the Commissioner, on his theory, had thrown back to the subsidiaries (R. 183). The expenses referred to were obviously the allocated expenses of Airco and not the amounts payable *by the subsidiaries* to Airco under their contracts.

No concession was made which would preclude the contention that if the amounts payable by the subsidiaries to Airco under their contracts are held not to be the income of Airco, then those amounts are deductible business expenses of the subsidiaries. The Tax Court, therefore, went beyond the scope of petitioners' concession when it stated that they "concede that if the issue which is raised by the pleadings is decided against them, then the deficiencies are those which have been determined by respondent" (R. 34).

III.

The issue in the Tax Court, as expressed, was whether the amounts payable to Airco are taxable to Airco as its "income" or taxable to the subsidiaries as their "income" (R. 29, 34). But, the underlying question was: should the obligations of the subsidiaries arising out of the contracts and out of the agency relationship be given any legal effect for tax purposes? The Circuit Court of Appeals erred, we submit, in according those obligations no legal effect, whether viewed as involving amounts payable as income to Airco or as amounts payable as expenses of the subsidiaries.

POINT THIRD.

The Circuit Court of Appeals was bound by the finding of the Tax Court that the principal-agent relationship existed and that the income from the operations of the subsidiaries, apart from agency compensation, was the income of Airco.

In reversing the Tax Court the Circuit Court of Appeals exceeded its powers of review.

The Tax Court recognized that the question of the ownership of income arising out of inter-corporate relationships and operations basically presents factual issues; and that the business of a subsidiary can be so directed, managed and controlled by its parent that the subsidiary constitutes, as a matter of fact, a mere incorporated branch, division, department or agent of the parent. Also, the Tax Court recognized that one corporation may be the contractual agent of another.

Further, the Tax Court was of the opinion that if either of these situations exists, the income derived from the operations of the subsidiary, is, in fact, the income of the parent as principal. In either, the parent is the "economic earner" of the income.

The issue below was the ownership of income, which was dependent upon whether an agency relationship existed between the subsidiaries and Airco. That issue was basically one of fact. The case was tried at length before the Tax Court, and it expressly found upon overwhelming evidence that "Petitioners were the corporate agents of Airco", and that "the income from the operations of petitioners . . . belonged to and was the income and property of Airco as principal" (R. 28).

At the time this case was decided by the Circuit Court of Appeals, the decision of this Court in *Dobson* v. *Commissioner*, 320 U. S. 489, was in effect. It has since been abrogated by the amendment to Section 1141(a) of the Internal Revenue Code which was made by Section 36 of the Act of June 25, 1948.*

Under the *Dobson* rule, which was then applicable, we believe it entirely clear that the findings of fact and decision of the Tax Court should not have been interfered with by the Circuit Court of Appeals. This case is surely one of "proper tax accounting" (*Dobson* v. *Commissioner*, *supra*, at pages 501-2).

The same conclusion follows, however, under the statute as it has now been amended. That statute directs that the Circuit Courts of Appeals shall have the same power in reviewing decisions of the Tax Court as in reviewing "decisions of the district courts in civil actions tried without a jury".

Rule 52(a) of the Rules of Civil Procedure deals with findings by a district court, in a case tried without a jury. With reference to that rule this Court recently said in *United States* v. *United States Gypsum Co.*, 333 U. S. 364, at pages 394-5:

> "'. . . In so far as this finding and others to which we shall refer are inferences drawn from documents or undisputed facts, heretofore described or set out, Rule 52(a) of the Rules of Civil Procedure is applicable. That rule prescribes that findings of fact in actions tried with-

* The section, as amended effective September 1, 1948, reads as follows: "The Circuit Courts of Appeals . . . shall have exclusive jurisdiction to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; . . ." (Public Law No. 773, 80th Congress, 2nd Session).

out a jury '*shall not be set aside unless clearly erroneous,* and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.' . . . A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." (Italics ours.)

But the Circuit Court of Appeals did not disagree with the Tax Court's finding that the principal-agent relationship existed. Nor did it hold that there was no evidence to support that finding or that it was, in any degree, erroneous. Indeed, as we have shown, the Circuit Court of Appeals, itself, affirmatively pointed out that Airco employed the subsidiaries as its agents (*supra*, p. 15).

Long before its decision in the *Dobson* case this Court had established the rules for review of actions at law tried by a district court without a jury. For example, in *McCaughn* v. *Real Estate Land Title & Trust Co.*, 297 U. S. 606, this Court held that a Circuit Court of Appeals was without authority to reverse a decision of a district court on the issue of contemplation of death. It said, page 608:

> ". . . The ultimate question for the decision of the trial court was one of fact and its general verdict was conclusive. The Circuit Court of Appeals was without authority to weigh the evidence and to make its own findings."

Similarly, prior to the *Dobson* decision, this Court had established the rules for review of decisions of the Board of Tax Appeals. In *Wilmington Trust Co.*

v. *Helvering,* 316 U. S. 164, where the issue before the Board was whether certain sales were short sales or ordinary sales, this Court reversed the Circuit Court of Appeals, which had reversed the Board. It said at page 168:

> "It is the function of the Board, not the Circuit Court of Appeals, to weigh the evidence, to draw inferences from the facts, and to choose between conflicting inferences. The Court may not substitute its view of the facts for that of the Board. Where the findings of the Board are supported by substantial evidence they are conclusive."

Therefore, whether this case is regarded as coming under the *Dobson* rule or under the scope of review applicable before that rule or presently applicable, the decision of the Circuit Court of Appeals was erroneous in that the Court exceeded its powers of review. The finding of the Tax Court that the income from the operations of the subsidiaries was the income of Airco as principal should have been accepted as conclusive by the Circuit Court of Appeals.

CONCLUSION.

The decision of the Circuit Court of Appeals should be reversed and the decisions of the Tax Court of the United States should be reinstated.

The decisions of the Tax Court are clearly supported by the proof that Airco not only created the income but is the only party having a beneficial interest in the income and the right to receive and enjoy it.

The decision of the Circuit Court of Appeals is founded upon a strained and unrealistic construction

of long established and always fully disclosed business relationships. It defeats the primary purpose of the income tax laws—to obtain revenue from the real owner of income. Such disregard of factual realities should not be approved.

The decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

ERWIN N. GRISWOLD
BOYKIN C. WRIGHT
EDGAR J. GOODRICH
JOHN A. WILSON
Counsel for Petitioners.

SHEARMAN & STERLING & WRIGHT
20 Exchange Place,
New York 5, N. Y.
Of Counsel.

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